Newly Independent States & Baltics Update

AGRICULTURE AND TRADE REPORT

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Spotlight on Foreign Direct Investment (FDI)

Introduction

Foreign direct investment (FDI) in the Newly Independent States (NIS) and Baltic countries, although lagging well behind other emerging markets, has increased in recent years. So far, FDI in the NIS and Baltics' food and related products sectors has been concentrated in beverages, confectionery, and tobacco products. An underdeveloped legal system, weak tradition of rule of law, inconsistent tax system, and deficient market infrastructure/information have fostered a high degree of risk and uncertainty, impeding FDI in the region.

Despite the slow progress, the long-term outlook (10 or more years) for the NIS and Baltic investment climate indicates that total FDI could increase at a quicker pace. Continued (and in some countries, improved) political stability, projected economic growth, and greater awareness of the benefits of FDI (such as technology transfer and increased employment) all point to greater growth. However, if the legal and policy environment improves more slowly than expected, or if growing nationalist sentiment turns public opinion against foreign investment, the outlook for FDI is less certain.

What is FDI and Why Does it Occur?

To analyze foreign direct investment (FDI) in the NIS and Baltic region, it is necessary to first define FDI and identify the factors that lead a company to invest in, rather than export to, another country. FDI occurs when a firm in one country makes capital expenditures, to either acquire assets of an existing firm in a foreign country with the intention of playing a role in managing those assets, or to establish a new firm. The U.S. Bureau of Economic Analysis, which compiles and reports U.S. companies' FDI activity, defines FDI as the acquisition of at least 10 percent of a foreign firm's assets.

By this definition, joint ventures, in which the investing firm has a minority interest, are included in FDI. The intent to have an active role in managing a firm's assets (either solely or with others) is what distinguishes FDI from portfolio investments. The parent firm in the source country is generally called a multinational enterprise (MNE), while the foreign entity in which the investment is made is referred to as the foreign affiliate. FDI can be characterized as vertical (involving upstream or downstream integration) or horizontal (the foreign affiliate produces the same or similar product as the MNE). Most FDI has taken place through acquisitions or mergers, and to a lesser degree through construction of new facilities, known as "greenfield" investment.

Global FDI outflows have been steadily increasing, and in 1995, reached a record $339 billion, up 35 percent from 1994 (all data are in nominal terms). FDI outflows grew a further 2 percent in 1996. During 1973-96, the estimated value of annual FDI outflows multiplied more than thirteen times (from $25 billion to $339 billion), while the value of merchandise exports multiplied about ten and one half times (from $575 billion to $6.1 trillion).

To understand these trends, it is necessary to look at the reasons why firms expand. For a firm to expand beyond a single plant, the benefits must be greater than the additional costs associated with coordinating activities across multiple plants. These benefits must be even greater for firms that engage in production activities that span several nations, because of the higher coordination costs.

In a perfectly competitive world, all firms have equal access to technology and none is big enough to influence

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prices. In this environment, FDI is not likely to take place because firms in the home market will have a cost advantage relative to a MNE. Instead, FDI is more likely to occur when competition is imperfect, products are differentiated (for example, due to brand-name recognition), and there are economies of scale. In addition, according to one theory, three conditions must be present simultaneously for firms to have a strong incentive to undertake FDI: Ownership, location, internalization (OLI, see box).

The OLI framework, although useful in determining conditions necessary for a firm to locate production overseas, has little to say about the choices among investment alternatives such as forming a joint venture or acquiring assets in an existing company. Generally speaking, technology-dependent or marketing-oriented firms are less likely to engage in joint ventures. However, firms may want to engage in joint ventures when the economic environment of the host country is risky or unfamiliar. This appears to be the case in the NIS and Baltic region, where a number of MNEs have chosen, at least initially, to form joint ventures with local firms.

The OLI Paradigm of FDI

Ownership advantage refers to assets that a firm can exploit on a relatively large scale. These include intellectual property (technology and brand names, for example), organizational and managerial skills, and marketing networks. Whatever the form, this advantage bestows on the firm market power or cost advantage relative to its competitors. This advantage is not sufficient for FDI to occur, however, because the firm can exploit these advantages through exporting from its home country.

Locational considerations include factors, such as import measures (such as tariffs and quotas), transportation costs, and cheap input prices, which make it more advantageous for a firm to produce in a foreign country rather than export. Locational considerations are also important in FDI decisions of vertically integrated firms, where production occurs in multiple stages and some key inputs may only be available in certain locations, or firms try to exploit differences in input costs across countries. Locational advantage also gives a firm the ability to be "close to its customers," in order to better (and more quickly) assess consumer demand and preferences.

Some economists view location as important, but see the need for other conditions to be present for FDI to occur. For example, empirical evidence indicates that trade barriers alone are not a strong magnet for FDI. Furthermore, focusing on locational considerations ignores the question of why some firms are able to exploit the advantages of that location.

The third and most abstract condition of the OLI paradigm is **internalization gains**. Internalization gains are related to those factors, such as knowledge-based capital, which make it more advantageous for a firm to carry out a transaction internally than to rely on external markets.

Internalization advantage is the major factor leading to FDI and establishing a foreign subsidiary rather than say, licensing a foreign firm to produce the good. It is more efficient to transfer knowledge-based assets internally and undertake the additional costs of establishing a foreign subsidiary than to undertake a licensing agreement, which has its own costs.

Licensing requires writing contracts and establishing value in an environment of asymmetric information. A firm may not want to reveal its process or product technology to a potential licensee because the other firm can reject the deal and copy the technology at little cost. Conversely, the licensee has little interest in purchasing a license without knowing exactly what it is buying, which requires revelations on the part of the seller. These costs, along with the idea that knowledge-based capital is easily transferred and can be a joint input into production of many plants, make FDI more likely.

Russia Leads NIS/B Region in FDI, U.S. One of Largest Investors

In absolute terms, **Russia** is the largest NIS/B recipient of **foreign direct investment**, with accumulated FDI stock (through 1996) estimated by various sources between $5 and $8 billion (table 1). The Russian statistical committee gives **total** accumulated (1994-96) **foreign investment**, which includes FDI, portfolio, and other types (not specified) of investment, at over $10 billion, of which FDI accounts for around half. Over two-thirds of total foreign investment (a breakout of FDI is not available) in Russia has been in Moscow city, Moscow oblast, Tatarstan, and St. Petersburg (table 2). **Kazakstan** and **Ukraine** are the next largest destinations, receiving around $1-3 in accumulated FDI each.

On a per capita basis, Russia and Ukraine rank much lower in accumulated FDI, behind the three Baltic countries of **Estonia**, **Latvia**, and **Lithuania**, as well as **Kazakstan**, **Azerbaijan**, **Turkmenistan**, and **Moldova** (figure 1). However, the lower per capita FDI levels in Russia and Ukraine don't necessarily mean that these countries are relatively less attractive to investors. For example, the United States is one of the world's largest recipients of FDI, yet on a per capita basis, it receives less FDI than smaller countries, such as Singapore.

The United States and European countries, such as Germany, Switzerland, and the Netherlands, have provided the bulk of FDI to the region, although countries with cultural or geographical ties have played larger roles in certain regions (table 3). For example, Turkey, Iran, Israel, and South Korea have been major investors in Central Asia and the Caucasus, while Scandinavian countries have been prominent in the Baltics, especially **Estonia**. Some NIS and Baltic countries (such as **Russia** and **Estonia**) have invested in their neighboring countries. The United States is the leading investor in **Russia**, **Ukraine**, and **Kazakstan**, the three largest NIS, and ranks in the top five for FDI in **Azerbaijan**, **Uzbekistan**, **Kyrgyzstan**, **Georgia**, and the **Baltics**.

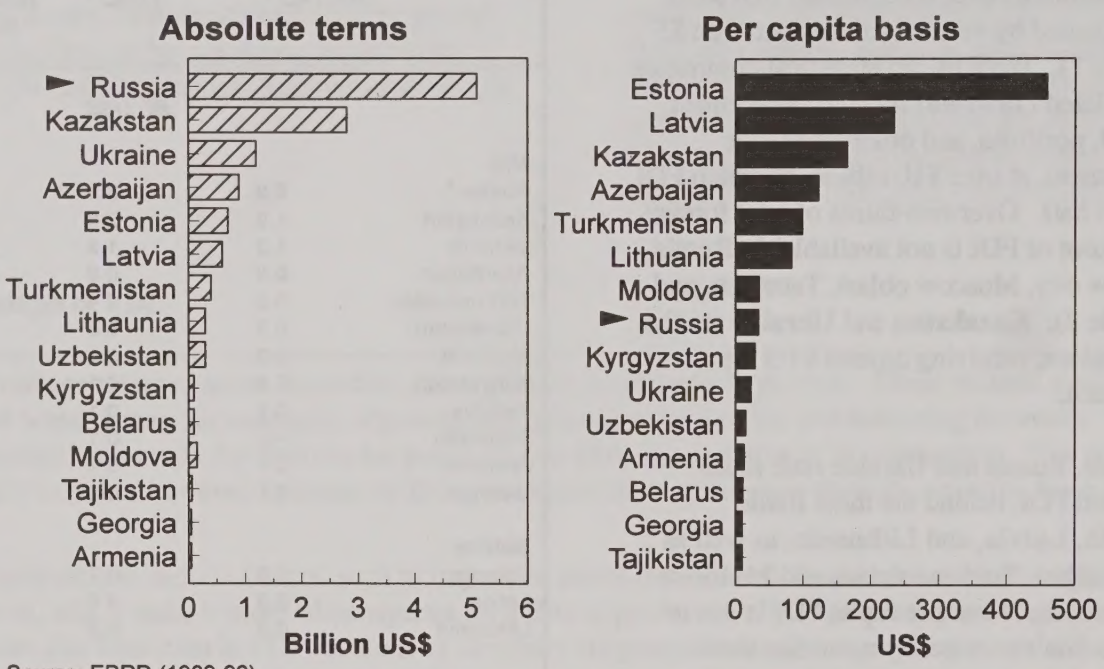
Figures on FDI by sector are less comprehensive. In **Russia**, FDI in the food sector has increased over the last 3 years, from less than 5 percent of total FDI in 1994 to around one-third in 1996 (as a share of total foreign investment, the food sector accounts for around 12 percent). In **Ukraine**, the share of total FDI in the food sector is around 10 percent, while in **Moldova**, it reportedly accounts for more than a quarter of total FDI. Investment has generally been greatest (as a share of total

Table 1--Accumulated FDI Stock, NIS, Baltics, CEE, and Other Emerging Markets

	UNCTAD [1]	EBRD [2]	Bus. Central Europe [3]
		Bil. US$	
NIS			
Russia [4]	5.9	5.1	6.5
Kazakstan	1.0	2.8	na
Ukraine	1.3	1.2	1.4
Azerbaijan	0.9	0.9	na
Turkmenistan	0.3	0.4	na
Uzbekistan	0.3	0.3	na
Moldova	0.2	0.2	na
Kyrgyzstan	0.1	0.1	na
Belarus	0.1	0.1	na
Tajikistan	--	0.1	na
Armenia	0.1	0.1	na
Georgia	0.1	0.1	na
Baltics			
Estonia	0.8	0.7	0.6
Latvia	0.8	0.6	0.5
Lithuania	0.3	0.3	0.5
CEE			
Hungary	15.0	13.3	15.0
Poland	13.7	5.0	12.0
Czech Rep.	5.3	6.6	7.2
Romania	1.6	1.4	2.2
Slovenia	0.7	0.7	1.6
Croatia	0.6	0.6	1.4
Slovakia	0.7	0.8	0.9
Bulgaria	0.5	0.5	0.8
Albania	0.3	0.3	0.3
Other Emerging Markets			
China	169.1	na	na
Mexico	71.5	na	na
Singapore	66.8	na	na
Brazil	108.3	na	na
Argentina	28.9	na	na
Thailand	19.6	na	na

na=not available.
-- = negligible.
[1] U.N. Conference on Trade and Development, 1996, estimate.
[2] European Bank for Reconstruction and Development, 1989-96.
[3] End of 1996.
[4] One source estimated FDI stock of $7.7 billion for 1991-96 (BISNIS/Dept. of Commerce, unofficial estimate).
Sources: Business Central Europe (Internet Securities); Financial Times, 11 April 1997, p. I; UNCTAD, 1997.

Figure 1--On Per Capita Basis, Russia Lags in FDI



Source: EBRD (1989-96).

Table 2--Foreign Investment by Oblast/City, Russia

	1995		1996	
	Mil. US$	*Percent*	*Mil. US$*	*Percent*
Russia, total [1]	2,796.7	100	6,506.1	100
Moscow city	1,312.0	47	4,291.6	66
Moscow oblast	205.0	7	411.9	6
Tatarstan	160.6	6	91.9	1
St. Petersburg city	160.6	6	145.3	2
Tyumen oblast	102.6	4	257.5	4
Samara oblast	69.7	2	na	na
Tver oblast	67.1	2	na	na
Nizhnegorod oblast	59.8	2	140.8	2
Novosibirsk oblast	58.4	2	71.1	1
Sakhalin	50.1	2	na	na
Magadan	na	na	149.3	2
Leningrad oblast	na	na	143.6	2
Khabarovsk	na	na	71.1	1

[1] Includes foreign direct investment (FDI), portfolio investment, and other investment.
Sources: Goskomstat Rossii, 1995, 1996.

Table 3--Foreign Investment by Major Country, Russia

	1995		1996		
	Mil. US$	*Percent*	*Mil. US$*	*Percent*	*Of which: FDI*
Total [1]	2,796.7	100	6,501.0	100	2,090.0
USA	812.9	29.1	1,695.2	26.1	849.2
Switzerland	419.8	15	1,323.4	20.4	110.5
Germany	293.5	10.5	288.9	4.4	208.5
UK	161.4	5.8	486.4	7.5	87.4
Belgium	105.3	3.8	65.0	1.0	38.7
France	95.9	3.4	41.7	0.6	37.4
Netherlands	83.3	3	979.6	15.1	28.9
Japan	74.5	2.7	na	na	na
Austria	71.8	2.6	163.6	2.5	142.9
Italy	na	na	75.2	1.2	15
Sweden	62	2.2	154.9	2.4	41.1

[1] Includes foreign direct investment (FDI), portfolio investment, and other investment.
Sources: Goskomstat Rossii, 1995, 1996.

Table 4--Foreign Investment by Sector, Russia

	1994		1995		1996	
	Mil. US$	*Percent*	*Mil. US$*	*Percent*	*Mil. US$*	*Percent*
Total investment[1]	1,053	100	2,797	100	6,506	100
Industry	1,032	98	1,202	43	1,810	28
Fuel industry	522	50	260	9	498	8
Machine bulding, metaleurgy	72	7	166	6	177	3
Chemical and petrochem.	na	na	165	6	100	2
Lumber, paper, cellulose	50	5	159	6	289	4
Food industry	**25**	2	**283**	**10**	**747**	**12**
Trade and catering	59	6	472	17	303	5
Financial, credits, insurance, pensions	na	na	399	14	1,925	30
Construction	103	10	199	7	na	na
General commercial activities (advertising, consulting)	na	na	137	5	1,537	24
Science and scientific services	26	2	135	5	na	na
Other	na	na	253	9	na	na
Non-ferrous metals	na	na	na	na	173	3
Communications	na	na	na	na	181	3

[1] Total investment includes foreign direct investment (FDI), portfolio investment, and other types of investment.
Sources: Goskomstat Rossii, 1995, 1996.

FDI) in the natural resource sectors (oil, gas, metallurgy). For countries without these resources, FDI has been more concentrated in the telecommunications and financial sectors (banking, consulting services, etc.).

However, this pattern has also occurred in **Russia**, where the share of total foreign investment in natural resource sectors has declined from initially very high levels, while investment in commercial and financial services has grown. In 1996, investment in commercial and financial services accounted for more than 50 percent of Russia's total foreign investment (table 4). Possible reasons for the decline in FDI in natural resources include increased diversification of Russia's economy, problems with early investment deals, and the strong role the government continues to play in regulating the energy sector.

It should be noted that data on FDI in the NIS and Baltic region vary by source, and FDI in the region is very difficult to track due to firm confidentiality and a still underdeveloped system of reporting cash flows. The definition of FDI (that is, the kind of investment included) may also differ from source to source (this is particularly true for data from NIS sources). For the purpose of this study, FDI is meant to include investment in a foreign company or establishment of a joint venture or wholly owned subsidiary in a foreign country. In table 1, data on FDI, as defined above, are presented, while tables 2-4 give total foreign investment, since a breakout is generally not available.

Types of FDI in NIS and Baltic Food Sectors

Foreign investors have formed joint ventures with NIS and Baltic companies, acquired shares in privatized plants, and established foreign subsidiaries. FDI has taken the form of modernizing or expanding existing facilities, as well as constructing new plants. While most foreign firms have invested to produce their product or a local brand for domestic consumers, a few are producing for export, generally to other NIS.

Many companies appear to be forming joint ventures or becoming minority share holders. As noted above, this likely reflects the risk perceived in doing business in the NIS and Baltic region. For example, on average only 70 percent of all U.S. affiliates in **Russia** are majority (over 50 percent) owned by the U.S. MNE, while the corresponding figure for all U.S. affiliates in all countries

is closer to 90 percent. On the other hand, companies with strong brand-name recognition appear to be choosing to form wholly owned subsidiaries or are investing as majority-shareholders.

Unlike FDI in most other countries, a sizable amount of the investment to date in the NIS and Baltic food sectors is greenfield, although it generally depends on the product and the type of investment. Possible reasons for the relatively large share of greenfield investment in the NIS/B food sectors include difficulties in valuating existing equipment, outdated or inferior technology/facilities (to the extent it is not cost effective to upgrade or refurbish), and impediments to the foreign firm's decision-making ability posed by other shareholders, who tend to be workers in the plant or local producers. High social costs related to acquiring an existing firm, such as worker benefits, upkeep of social infrastructure (schools, housing, etc.), and difficulties in shedding workers also make greenfield investment more attractive. However, as domestic firms continue to upgrade infrastructure and technology, the market for buying/selling shares develops, and as social services are turned over to municipalities to run, direct investment in existing assets should grow.

FDI in NIS/B Food Sectors Primarily in Beverages, Confectionery, Tobacco

ERS has compiled a database on FDI in the NIS and Baltic food processing industries, based on several years of monitoring numerous data and informational sources. This report focuses on FDI in the food processing, related products (such as alcoholic beverages and tobacco products), and catering (primarily fast food establishments) sectors, although there has been sizable foreign investment in other food-related industries, such as packaging.[1]

Based on the number of firms investing and the amount of investment, FDI in the NIS and Baltic food sector has been concentrated in three main areas: beverages (beer, wine, and non-alcoholic beverages), confectionery (candy, cookies, etc.), and tobacco processing (table 5). Other significant sectors include sugar and sweeteners (generally for the development of new products such as high fructose corn syrup and sugar-free sweeteners), ice cream, fruit and vegetable processing, and baby food. Cotton processing has also received a sizable share of FDI in Central Asia. Catering is a major area of FDI in all NIS and Baltic countries, and has generally included some degree of vertical integration back to the processing and distribution levels.

One reason for the concentration of FDI in the three main areas is strong domestic demand for these products (especially in higher-income niche markets). Moreover, many of these products face relatively higher import protection and carry strong brand recognition, which was initially established through exports (table 6). In many cases, there was limited domestic competition for the product in terms of variety, packaging, or quality.

These sectors also generally fit the OLI framework described above. Most of the firms involved in these sectors possess assets that can be exploited on a large scale: technology, brand names, organizational skills, and marketing strategies. Second, given rising import protection (primarily through tariffs) for many of these products and increasing transportation costs, there is a locational advantage for manufacturing these products in the host country. This is particularly clear in **Russia**, where internal regional markets are growing (for example, in the Urals and Siberia regions) and local production within Russia reduces the cost of transporting products to these less accessible locales.

Concerning internalization, there are several reasons why it is more advantageous for the MNE to establish production in the host country than license a domestic firm to produce the good. First, given strong brand reputation and recognition, quality is a primary concern of the MNE. Licensing with a domestic company, which may have only limited experience in effective quality control, could lead to production of a lower quality good, thus diminishing the value of the brand name.

Second, given underdeveloped legal institutions and lack of contract enforcement in most of these countries, licensing is very costly. On a related point, weak intellectual property rights protection (due to insufficient laws and enforcement) make many firms less willing to share their production technology and other information, for fear of copyright or patent infringement.

Relative to Other Emerging Markets, FDI Lags in NIS Region

While the climate for investment in **Russia** and some of the other NIS is improving, investors still face a daunting

[1]For the purposes of space, the term "food sector" will include food processing, related products, and catering. Although catering is generally considered a service industry, it is included in this study since in many NIS and Baltic countries, investment in catering has involved some degree of vertical integration back to the processing and distribution level.

Table 5--Leading NIS and Baltic Food Sectors for Investment

Product	Major Firms **Russia**	Areas of investment **Russia**	Other NIS and Baltics [1]
Beer	AMS (Germany), BGI (France), Sinebrychoff (Finland) DAB/Uhde (Germany), Baltic Beverage Holding (Scandanavia), Spohisel (Spain), Holsten (Germany)	Kaliningrad, St. Petersburg, Moscow, Nizhnyi Novgorod, Yaroslavl	Ukraine, Belarus, Estonia, Latvia, Lithuania, Kazakstan Uzbekistan
Non-alcoholic beverages	Coca-Cola, PepsiCo, Corol (Italy), Hero (Germany), Dohler-Moscow (Germany), AUR (France)	Buriatia, Nizhnyi Novgorod, St. Petersburg, Ekaterinburg, Samara, Vladivostok, Volgograd, Moscow, Orel, Novosibirsk, Krasnodar, Rostov, Kazan	All NIS and Baltic countries
Confectionery	Nestle (Switzerland), Danone (France), Mars (U.S.)	Moscow, Samara	Ukraine, Lithuania, Kazakstan Kyrgyzstan
Sugar/sweeteners	WorkPoint AG (Switzerland), Sucden Kerry (France), Sutek (Turkey), Cargill (US), Starcosa (Germany)	St. Petersburg, Tula, Moscow, Tatarstan Stavropol, Orenburg	Ukraine
Ice cream	Nestle, Ben & Jerry's,[2] Baskin-Robbins, Far East Import Co. (US)	Moscow, Karelia, Magadan	
Baby food	Heinz, Nestle, Dexma GmbH (Germany), Parmalat (Italy), Noga (Switzerland)	Stavropol, Saratov, Belgorod, Yaroslavl, St. Petersburg, Nizhnyi Novgorod	Ukraine, Kazakstan, Turkmenistan
Fruit/vegetable processing	Winsome Food Tech. (US), Concord (US) Frito-Lay (planned)	Novosibirsk, Volga	Ukraine, Estonia, Kazakstan Latvia, Turkmenistan, Uzbekistan
Catering	McDonald's, PepsiCo (Pizza Hut, Taco Bell), Dunkin Donuts	Moscow, St. Petersburg, Nizhnyi Novgorod	Ukraine, Georgia, Belarus Moldova, Baltics
Tobacco	Philip Morris, RJR International, BAT (UK), FKT Handels-Gesellschaft (Germany), Rothmans (UK) Brook Overseas (US)		Ukraine, Moldova, Belarus Estonia, Lithuania, Kazakstan Kyrgyzstan, Uzbekistan

[1] Includes FDI from companies not identified in this table.
[2] Ben & Jerry's pulled out of Russia in 1996.
Sources: Various issues of Interfax Food and Agriculture Report, OMRI Daily Report, AgraEurope.

Table 6--Russian Imports of Primary FDI Products

Product	1994	1995	1996	HS code used [1]	Applied tariff [2]
		$1,000			*Percent*
Non-alc. beverages	244,474	128,297	135,900	22.01, 22.02	15-25, some specific tariffs
Alcoholic beverages	939,472	1,805,836	864,578	22.03-22.08	Mixture of ad val. and per unit, mostly 3-digit ad val. equiv.
Beer	76,578	153,538	92,885	22.03	0.6ECU/liter=106% ad val.
Wine	272,289	515,230	396,405	22.04	Mostly specific tariffs: 0.12-1.32ECU/liter= 13-143% ad val.
White sugar	316,103	812,049	668,380	17.01.99.100	25% or no less than .07ECU/kg
Confectionery	1,360,253	585,353	530,548	17.04,18.06, 19.05	15-25/no less than 1.5ECU/kg
Chocolate	711,487	400,496	190,423	18.06	0.6ECU/kg=39%
Ice cream	126,205	70,262	64,389	21.05	15
Baby food	na	42,179	42,321	19.01.10	5
Tobacco products	342,916	500,300	397,849	24.02	30 or no less than 3ECU/1,000 units
Total of above	3,329,424	3,944,276	2,703,966		
Total 1-24 HS	10,699,600	13,040,600	11,166,500		
Share of HS 1-24	31	30	24		

[1] Harmonized System (HS) tariff code.
[2] As of mid-1997.
Sources: Tamozhennyi komitet Rossiiskoi Federatsii, ERS.

combination of political and economic risk, uncertainty, and a vast array of infrastructural and policy-related impediments.

On the positive side, the political climate in **Russia** and many other NIS has improved over the last year with the appointment of a number of reform-minded officials and the cessation of hostilities in several NIS. The macroeconomy has also begun to stabilize during the last year. Inflation is the lowest since the introduction of economic reforms in 1992, exchange rates (in real terms) are beginning to stabilize, and real interest rates have fallen. Moreover, in most NIS (**Armenia**, **Georgia**, **Azerbaijan**, **Kyrgyzstan**, **Belarus**, **Kazakstan**, **Uzbekistan**), GDP has already begun to grow in real terms, and is projected to grow in **Russia** and **Ukraine** in the next 1-2 years.

The long-term potential for economic growth in this massive, populous (300+ million), and resource-rich region is enormous, particularly in the agribusiness sector. One current incentive for investors is the large, skilled labor force with salaries below those in many developed market economies.

Despite these conditions, the obstacles and risks faced by foreign investors in the NIS region remain very high relative to many other countries. Compared with other emerging markets, FDI in **Russia** and most NIS lags behind. While total FDI (accumulated) in Russia as of the end of 1996 was estimated at around $5-8 billion, the U.N. Conference on Trade and Development estimates total FDI at well over $150 billion in China, over $100 billion in Brazil, and over $15 billion in Hungary (table 1).

It should be noted that, while there are real impediments to investment in the NIS (and to a lesser degree Baltic) region, these countries have been independent for only 5 years and are still undergoing a tremendous political and economic transformation. Therefore, lower accumulated FDI, relative to more developed emerging markets, is to be expected.

Uncertainty and Risk Reduce FDI in NIS Region

A main reason why FDI in the NIS region is so much lower than in other countries is the risk and uncertainty associated with the investment climate in the region. One definition of risk, which distinguishes it from uncertainty, is that risk is subjectively measurable. That is, decision makers can attach a probability to alternative possible outcomes of an investment decision.

In a risky environment, investment occurs if returns are high enough to compensate for the associated risk. In an uncertain environment, the result may be market failure and little or no investment occurs. The investment that does occur tends to be modest investments by major corporations, to establish brand identification in what may be a lucrative market in the future.

The rule of law in western capitalist countries reduces the uncertainty associated with business activity. Although some NIS have passed foreign investment laws that provide (on paper, at least) some degree of guarantee against expropriation, transfer of profits, and rights of transfer of private property, these laws are often unclear and/or contradictory. Moreover, most of these countries still lack fundamental laws, such as legislation that permits the free sale and purchase of land. Some NIS parliaments (such as **Russia's**) are considering revisions that could weaken existing foreign investment laws.

More than having laws on the books, enforcement mechanisms and a "track record" in enforcement are necessary prerequisites for a more certain investment climate. In most NIS, an uncertain regulatory climate, lack of transparency in the legal system, and conflicting rules all increase uncertainty in the investment climate. Laws are often vague, and have wide leeway in interpretation, which invites corruption and inconsistent interpretation. Moreover, in many NIS, especially **Russia** and **Ukraine**, regional and local governments often introduce measures that run counter to federal regulations, or don't enforce federal laws and decrees. This lack of administrative efficiency counters the benefit of having laws and contributes to uncertainty.

High Taxation Rates and Other Costs Raise Transactions Costs

In addition to a vague or non-existent commercial code, many NIS have inconsistent and nontransparent tax laws, as well as numerous and high taxes. In addition to increasing uncertainty, they also directly reduce the expected rate of return on an investment and usually require a higher rate of return to compensate for the additional fees and payments associated with it. Poor transportation and communication infrastructure also increase costs of doing business. Less obvious but also significant are lack of contract enforcement, effective dispute resolution mechanisms, and modern credit institutions, all of which raise the transactions costs associated with business activities.

Countries can act to lower business costs, by introducing

measures such as tax exclusions, free trade zones, and grace periods. While some NIS have introduced such programs, the uncertainty surrounding their implementation often counteracts the benefits. Bilateral investment treaties, such as those in progress between the United States and most NIS, can help reduce uncertainty as well as business costs by indicating the country's commitment to a predictable code of business behavior.

Lack of an Equities Market for Existing Assets Also Dampens Investment

Much of the existing capacity in the NIS food processing sector is old and in poor repair, but whether it is still useful depends on its acquisition price. If a plant can be purchased at a reasonable price, refurbishment may be more economical. Other plants may be more valuable as scrap material and will be closed. But without an equities market there is no way to discover the "value" of these assets.

Another impediment to foreign investment is excess capacity, which exists in many areas of the food processing sector. Investors are hard pressed to invest in sectors where there is already excess capacity and operating costs are high. Excess capacity and difficulties in determining the plant's value, either in production or as scrap, deter investment.

Outlook for FDI in NIS and Baltic Region

Several factors point to improved long term (10 or more years) prospects for FDI in the NIS and Baltic countries. Despite possible setbacks that could slow improvement in the region's investment climate, continued progress in market reforms and stabilization of the region's economic and political environment is expected to lead to increased growth in FDI over the long term.

First, the uncertainty that has plagued the investment climate in the NIS should be reduced over time, as regulatory mechanisms are strengthened and a track record in law enforcement develops. This should give investors more certainty in determining the expected return on their investment.

Second, the region has the potential to attract FDI flows because it has a large, well-educated labor force with relatively low wage rates. Also, it is a big enough market for firms to capture economies of scale and reduce design and marketing costs.

Third, continued political stability, the development of a market economy, and sustained economic growth, all of which are forecast for the NIS region, should also facilitate greater FDI flows to the region. This is supported by the fact that FDI generally moves between developed market economies, or is mostly concentrated among developing economies with relatively high growth rates. In fact, this is what occurred in several Central and Eastern European countries, which saw increased FDI flows once their economies became more market-oriented and began to grow.

Moreover, there are benefits to the NIS and Baltic countries of attracting FDI, which should provide an incentive to make the investment climate less risky. These benefits include increased employment, availability of new technologies that may spill over and be adopted by domestic firms, and increased productivity, which enables higher wages and an improved standard of living for the host country. More generally, FDI should help spur economic growth, and thereby the host country's real income.

However, domestic backlash over foreign ownership of assets could mitigate the perceived gains from investment. Nationalist sentiment has been growing in the region, and while mostly directed at imported products, it could negatively affect the public's perception of foreign investment. Many Russians and others feel that privatized plants and factories were sold at too low of a price, and may believe that foreign investors are taking advantage of this situation. If public sentiment is strong enough, politicians may be tempted to introduce limits on foreign investment.

Another factor in improving the investment climate in the NIS and Baltic region is the countries' membership in the World Trade Organization (WTO). To join the WTO, the countries will have to change or introduce new laws to conform with rules on investment, intellectual property rights, taxation, etc. In addition, funding requirements of the IMF, World Bank, and other organizations should also bolster the legal and policy framework necessary to reduce risk and uncertainty.

However, if laws on investment, private property, and taxation are not developed, or remain ambiguous and/or weakly enforced, the region will continue to be less attractive for FDI. A related issue is crime and corruption: Without effective safeguards against violence and unfair business practices, foreign investors will require greater returns on their investment, or not invest at all.

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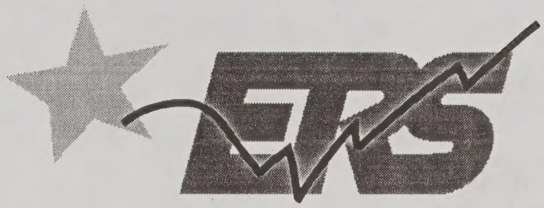

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